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SUBJECT: JAMAICA'S FISCAL POLICY 2006/7: MORE OF THE SAME?

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¶1. (SBU) Summary: The GOJ expenditure budget for FY 2006/7 is expected to be announced on April 12. Against this background, emboffs met with Ministry of Finance (MOF) officials on March 30 to discuss the GOJ'S fiscal program. The GOJ, as expected, will miss its FY 2005/6 balanced budget target (ref. A) due to low revenues resulting from external shocks, administrative reform delays, and poor tax compliance. The officials stated that the reduction of the debt-to-GDP ratio remains a priority, but privately acknowledged that spending on social and physical infrastructure will also be prominent in the new budget, due in part to the likelihood of a general election this year. Finance Minister Omar Davies will have to strike a balance between fiscal discipline and election year spending in order to please both his new political master, Prime Minister Portia Simpson Miller, and the agencies who have kept Jamaica's credit rating attractive to institutional investors. End summary.

Fiscal accounts suffer from sluggish revenues

¶2. (SBU) Emboffs met on March 30 with three MOF officials: Acting Deputy Financial Secretary Darlene Morrison, Acting Senior Director of the Fiscal Policy Management Unit, Courtney Williams, and Senior Macro Economist, Richard Bailey. After outlining the budget process, Williams told emboffs that a number of external and domestic shocks combined to dampen GOJ'S fiscal operations during the year. He noted that the fiscal program had been on track during the first quarter (April-June), but that these factors subsequently derailed it. (Note: Williams privately told emboff that the data suggests that the fiscal deficit for 2005/06 could be in the region of three percent of GDP, one percentage point above the revised target. End note.)

¶3. (U) The rising cost of oil actually reduced GOJ revenues because it is subject to a fixed tax, rather than an ad valorem one. This, coupled with falling demand, led

the GOJ to table a new energy policy in March 2006 which included, inter alia, a value-added tax on gas. Williams noted, however, that the issue was politically explosive, and pointed to three gas riots since 1979, the most recent of which followed the planned introduction of just such a tax in 1999. An impact study showed that this unrest cost the country almost three percent of GDP, much more than the incremental tax benefits would have provided.

¶4. (SBU) Weather conditions contributed to higher-than-expected inflation. Viewed amidst fixed incomes, this resulted in reduced consumption and in turn a fall in consumption- and income-based taxes. At the same time, a number of revenue improvement measures - especially new tax measures - scheduled for the first fiscal quarter were not implemented until December 2005. Williams stated that preliminary indications are that these measures are beginning to take effect, and that improved results should be expected in the coming fiscal year.

Tax compliance a major challenge

¶5. (SBU) Given a recent MOF report showing a tax compliance rate of 58 percent, emboffs asked the officials to comment on the extent and impact of the problem on revenues. Morrison pointed out that compliance was a major component of administrative reform, with the intent to establish a taxpayer registration number (TRN) to combat tax evasion. However, she also stated that enforcement must improve; while punitive laws exist they are not being vigorously applied. Morrison opined that judges did not appear to understand the gravity of the problem, generally applying only minimal fines to tax

evaders.

¶6. (U) She also acknowledged that private sector auditors are far more sophisticated than their public sector counterparts, and are able to outwit them during audits. This prompted the GOJ to seek the assistance of Canadian forensic auditors for training. Morrison said that the tax department would welcome any assistance from the USG in order to improve tax compliance and enforcement procedures. Post will report septel with specific suggestions for outreach.

¶7. (SBU) Williams said that the GOJ actually detected increased tax avoidance and evasion following the implementation of new tax measures in April 2005 (ref. B), indicating that Jamaica has reached its "taxable limit." Emboff therefore asked the MOF team whether they were considering tax consultant Ethlyn Norton-Coke's proposal to increase consumption taxes and reduce or eliminate income taxes. Morrison stated that the proposal was being considered, and that the new Director of Taxation, Vinette Keane, was focused on broadening the tax base. Williams, who has privately been dismissive of Norton-Coke's proposal, reiterated the regressive nature of her suggestion and its potential impact on society's most vulnerable groups. He noted that both U.S. and European countries were generally moving away from regressive taxation regimes.

New Budget, Old Priorities

¶8. (SBU) With debt servicing costs accounting for almost 70 percent of the expenditure budget, Econoff asked the MOF officials to comment on the current debt-to-GDP ratio, as well as whether debt repayment would remain the major priority in the new budget. Williams stated that the ratio was in the region of 140 percent, and that MOF's

medium-term target was 100 percent, compared to the international benchmark of 60 percent. Given Jamaica's recent history - notably the GOJ bailout of the financial sector following the crisis of the mid-1990s - he said that 100 percent was a more reasonable target.

¶9. (SBU) Morrison pointed out that while the reduction of the debt-to-GDP ratio remained the priority, physical and social infrastructure projects will also feature prominently in the 2006/07 budget, an indication that this could be an election year, as political observers have increasingly suggested. She further revealed that the GOJ would not pursue a balanced budget this year due to the continued recovery of the economy and the need to increase capital spending for rehabilitation purposes. In addition, the GOJ will spend a significant sum on capital projects associated with the 2007 Cricket World Cup (CWC - ref. C). The current prediction is that the GOJ will aim for a fiscal deficit of one percent of GDP.

¶10. (U) When asked about the possible impact of the CWC on fiscal operations, the officials hoped that consumption and corporate taxes would increase, thereby raising additional revenue to offset the increased debt. However, given heavy GOJ borrowing to finance these capital expenditures (and also the new Memorandum of Understanding (MOU) with the public sector: ref. D), emboffs raised concerns about high interest rates. Morrison asserted that interest rates were actually expected to trend down, particularly with moderating inflation. Williams admitted that falling inflation could be stymied by the ongoing drought, which led to a series of bush fires in 2005, affecting agriculture production and causing a spike in food prices. Regarding the MOU, Morrison assured emboffs that it would be concluded before the budget presentation on April 12.

Comment

¶11. (SBU) Williams is a close Embassy contact with a reputation for candor, so it is reasonable to accept his analysis that the GOJ will miss its revised fiscal deficit target of two percent of GDP. Nevertheless, his

prediction of three percent will not impact significantly on investor sentiment, as most observers have anticipated this. Of greater concern is that the GOJ will likely provide for a deficit of only one percent of GDP for the upcoming fiscal year, predicated on the need for increased capital spending to fund rehabilitation and infrastructure associated with Cricket World Cup 2007. This target is overly ambitious. With hints of an early election, CWC costs that may exceed expectations, and with weather experts predicting another stormy summer, this deficit target could be significantly exceeded. Any such deviation could lead international agencies to reduce Jamaica's rating, prompting among other things an increase in the rate at which the country can raise funds on the international capital market. Against this background, it is clear that the tax structure and enforcement regime is in need of complete reorganization. While this would be political suicide prior to a general election, one can only hope that whichever party emerges victorious will recognize this vital need if Jamaica is to continue its climb out of the economic doldrums. End comment.

JOHNSON